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SUBJECT: MEXICO'S GOVERNMENT BUILDING SUPPORT FOR FISCAL

REFORM

Summary

¶1. (SBU) President Calderon and members of his administration have been working with Congress to build support for fiscal reform. The government would like for the reform to be approved during a special session of Congress this summer so the new measures can be incorporated into the President's 2008 federal budget proposal, which is due to the Chamber of Deputies on September 8. To secure the initiative's passage in Congress, the government will need support from the Institutional Revolutionary Party (PRI) -- which, among other things, is pushing for more resources for the states and refusing to levy the value-added tax food and medicine. The debate over fiscal reform is currently in a holding pattern because of the close PAN-PRI election in Yucatan on May 20. Several contacts have told econoff that the PAN should be able to count on PRI support for fiscal reform if the PRI candidate wins the race, but not necessarily if she loses. The government has not disclosed the specifics of its reform proposal but says it wants to simplify the tax system, reduce administrative costs, make the tax system more transparent and equitable, and increase tax collection by 2-3% of GDP in the coming years. Some observers have said that fiscal reform will be more difficult to pass than pension or energy reform, and have opined that the final reform may not be as comprehensive as it should be. End Summary.

The Importance of Fiscal Reform

¶2. (SBU) For many, Mexico's most pressing public policy problem is that the government relies on oil-related revenues to finance 38% of its spending, and that states and municipalities depend on transfers from the federal government for more than 90% of their revenues. In Latin

America, only Guatemala has a lower tax collection rate than Mexico. Reasons for such poor collection include a large underground economy, complex tax laws, numerous preferential regimes and exemptions that allow companies and individuals to significantly reduce effective tax rates, and a generalized "why should I pay?" sentiment that stems from a lack of confidence in how tax dollars will be used and from a feeling that everybody wants someone else to pay.

13. (U) Regarding the value-added tax (VAT), numerous exemptions (e.g. books and public transportation) and a large proportion of goods and services with a zero tax rate (e.g. food) mean that only a small part of the potential base is actually being taxed. Although the zero-rating and exemptions are often perceived as helping poorer families, an OECD study shows that more affluent households gain the most since they buy more goods in general, including those with a zero tax rate.

Government Lobbying for Support

14. (SBU) President Calderon and members of his administration in recent weeks have been meeting with Congress to build support for fiscal reform. A contact from the Chamber of Deputies told econoff that the government would like to call a special session of Congress to debate the proposal in the June-July timeframe. Marco Oviedo Cruz, the Director of Financial Planning in the Finance Secretariat (strictly protect), told econoff on May 14 that the government would like to have the reform signed into law before the President's federal budget proposal is due to the Chamber of Deputies on September 8 so the new measures can be included

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in the 2008 budget. He added that, ideally, the proposal would be approved before the ordinary session of Congress opens on September 1 because discussions at that time will be dominated by the 2008 budget. Gustavo Madero, the President of the Senate Finance Committee, (strictly protect) echoed this timeline, and added that Plan B was to approve fiscal reform between September and December 2007 and Plan C was to approve it between February and April 2008. Madero said that the window of opportunity could be lost after April 2008 because the lower house of Congress would be gearing up for the 2009 elections.

15. (SBU) As Calderon's National Action Party (PAN) lacks a majority in Congress, it will need support from the Institutional Revolutionary Party (PRI) to pass the initiative. Several contacts have told econoff that the debate over fiscal reform is currently in a holding pattern because of the May 20 election in Yucatan -- the first local race held during the Calderon administration. The PAN candidate hopes to retain the state's governorship, while the PRI is betting on taking back a state it governed for more than 60 years. Some members of the PRI are already crying foul and alleging that Calderon is interfering in the election. Both HSBC economist Alejandro Martinez (strictly protect) and Oviedo Cruz said that the PAN should be able to count on PRI support for fiscal reform if the PRI candidate wins the race, but not necessarily if she loses. Madero implied the same when he told econoffs that the PRI was using this election as a "threat." He added, however, that his counterparts in the Chamber of Deputies have been willing to work closely with the Senate and the PAN to pass the reform.

16. (SBU) The PRI is not lending its support as readily as it did earlier this year for pension reform. The PRI, which controls 17 state governments, has said it wants states to have more control over the funds they receive from the federal government. Oviedo Cruz acknowledged that the government agrees that the states need more resources, but added that it wants states to show more transparency in how they spend public funds. Finance Secretary Carstens has said

publicly that he does not want to give the states more money from the federal budget or increase their ability to raise funds on their own without guarantees that the money will be spent responsibly.

¶7. (SBU) Moreover, senior PRI members have said publicly that their party is willing to support fiscal reform as long as it does not include taxing food and medicine -- long a controversial issue here -- and as long as the Secretariats of the Environment, Social Development, and Agriculture are decentralized. The PRI claims that these secretariats at the state level are used to curry favor with the public and build political support.

¶8. (SBU) Echoing comments from a contact at the stock exchange, Madero said he expects a "light" fiscal reform because the government wants the initiative passed before September 8. In his opinion, the final reform "will not be in proportion to the size of the problem." Madero told econoffs that fiscal reform is significantly more difficult to pass than pension or energy reform because everyone is affected by fiscal reform, not just a particular union or segment of society. Moreover, while everyone agrees what the problem is, ideas about how this problem should be solved vary widely. On a positive note, Madero praised Calderon's and Finance Secretary Carstens' negotiating skills, noting the improvement from the previous administration.

Details of Proposal Score

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¶9. (SBU) The government has not disclosed the specifics of its plans to overhaul the tax system, but Under Secretary of Revenue Fernando Sanchez Ugarte has said publicly that the Finance Secretariat's tax reform proposal aims to simplify the tax system, reduce administrative costs, and make the tax system more flexible, transparent, equitable, and better able to promote competitiveness. Oviedo Cruz told econoff that their goal is to boost revenues by 2-3% of GDP in the coming years.

¶10. (SBU) Oviedo Cruz told econoff that the government would not impose the value-added tax (VAT) on food and medicine in its proposal because it knows that this would never be approved in Congress. He said that fiscal reform "is already becoming controversial," noting a leaked recording in which press reports say Carstens asked deputies to reconsider the subsidies the government gives people whose salary is less than the equivalent of four minimum wages. This subsidy completely covers these workers' tax bill, and even leaves them with a little extra. Oviedo Cruz told econoff that the government does not plan to go after people in the lower income brackets to increase tax collection.

¶11. (SBU) Gustavo Madero shed more light on the proposals currently being discussed. He acknowledged that the idea of charging the VAT on food and medicine has been discarded, but noted that they may try to find another way to do essentially the same thing for food items, which have the potential to notably increase revenues (Comment: he did not specify how they would accomplish this, but press reports have noted a few alternatives, including having the government eliminate tax refunds for food producers. End Comment). He added that the idea of charging the VAT on food has become so politicized that alternative proposals could not even resemble a VAT. Madero said that another proposal being discussed is a flat tax. The problem the PAN, and the PRI in particular, face is eliminating the unions' privileges and deductions. He opined that a way around this problem is to eliminate deductions in general and to simplify the tax system.

¶12. (SBU) In Madero's opinion, the government should strive

to increase the small base of contributors. He said that about 80% of total tax collection comes from the rich, and that the poorest 40% of the population do not pay taxes. He wants to capture more tax revenue from the people in the middle of this spectrum. Madero also would like to see the states and municipalities increase their tax collection. He said that the federal government currently collected 92% of taxes, and the states only 8%. However, the government spends 48% of federal funds, and the states 52%. There are very few local taxes, and states and municipalities are poor at enforcing tax collection. As an example, he cited the property tax, a municipal resource, which only represents 0.3% of GDP.

¶13. (SBU) Comment: The importance of implementing a reform that increases tax collection, reduces tax evasion, makes government spending more efficient, and lowers the country's dependence on oil revenues cannot be understated. Such a plan is needed to create a broader and more stable base to finance government spending and to meet growing social spending needs. While it is disappointing to hear some already saying that the reform may be "light," it is not completely surprising given the fact the government is asking people to pony up more money. It is better to have a "light" reform that gets passed than no reform at all. End Comment.

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